United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

SEP - 1 1998

Honorable Ralph Regula
Chairman, Subcommittee on
Interior and Related Agencies
Committee on Appropriations
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

House Report 105-609 accompanying the Department of the Interior and Related Agencies Appropriations for Fiscal Year 1999, as passed by the House of Representatives, requested the enclosed report from the Minerals Management Service (MMS) addressing issues related to MMS's proposed Federal crude oil valuation rulemaking. We also have included an update on the status of our rulemaking efforts since our June 3, 1998, report to the Committee.

A similar letter is being sent to the Honorable Sidney R. Yates, Ranking Minority Member of the House Appropriations Subcommittee on Interior and Related Agencies; the Honorable Slade Gorton, Chairman of the Senate Appropriations Subcommittee on Interior and Related Agencies; and the Honorable Robert C. Byrd, Ranking Minority Member of the Senate Appropriations Subcommittee on Interior and Related Agencies.

Sincerely,

Kenneth L. Smith
for
John Berry
Assistant Secretary
Policy, Management and Budget

Enclosure

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SEP - 1 1998

Honorable Sidney R. Yates
Ranking Minority Member
Subcommittee on Interior and Related Agencies
Committee on Appropriations
House of Representatives
Washington, D.C. 20515

Dear Mr. Yates:

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Honorable Slade Gorton
Chairman, Subcommittee on
Interior and Related Agencies
Committee on Appropriations
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

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Sincerely,

Kenneth L. Smith
for
John Berry
Assistant Secretary
Policy, Management and Budget

Enclosure

United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

SEP - 1 .=3

Honorable Robert C. Byrd
Ranking Minority Member
Subcommittee on Interior and Related Agencies
Committee on Appropriations
United States Senate
Washington, D.C. 20510

Dear Mr. Byrd:

House Report 105-609 accompanying the Department of the Interior and Related Agencies Appropriations for Fiscal Year 1999, as passed by the House of Representatives, requested the enclosed report from the Minerals Management Service (MMS) addressing issues related to MMS's proposed Federal crude oil valuation rulemaking. We also have included an update on the status of our rulemaking efforts since our June 3, 1998, report to the Committee.

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Sincerely,

Kenneth L Smith
for
John Berry
Assistant Secretary
Policy, Management and Budget

Enclosure

REPORT OF THE MINERALS MANAGEMENT SERVICE ON OIL VALUATION RULEMAKING

House Report 105-609 on the Department of the Interior and Related Agencies Appropriations for Fiscal Year 1999, requests a report from the Minerals Management Service (MMS) addressing issues related to MMS's proposed oil valuation rulemaking. The Report says:

> The Committee continues to have reservations regarding the Minerals Management Service's (MMS) proposed crude oil valuation rulemaking. Because of these concerns, the Committee expects to receive a written report no later than August 30, 1998, detailing how MMS is dealing with the following issues: (1) how it might permit a lessee selling oil at arm's length at the lease to continue to base its royalties on its gross proceeds; (2) how the use of so-called tendering programs, arm's length sales and arm's length purchases at the lease of a portion of the lessee's production in a given field can be valued on its remaining production; and (3) how it will address the issue of deductions for value added to oil moved downstream from the lease in order to derive a value of production at the lease.

The MMS's responses to these issues and an update on the status of our rulemaking efforts since our June 3, 1998, report to the Committee follows.

How MMS would permit a lessee selling oil at arm's length at the lease to continue to base its royalties on its gross proceeds

The ability to use arm's-length gross proceeds as royalty value would not change under the proposed regulations. The regulations would continue to permit lessees who sell their Federal lease production at arm's length to use the gross proceeds from such sales as royalty value. This is true whether the sale occurs at the lease or at some distant point. Where sales occur away from the lease, the lessee would be eligible for a transportation allowance for its actual costs of moving the production to the point of sale.

We believe that most Federal lessees would be able to apply arm's-length gross proceeds as royalty value in most situations. But for the larger, integrated companies that do not sell their production at arm's length but instead refine it themselves, index pricing (or, in the Rocky Mountain Region, benchmark valuation) would be required.

How tendering programs, arm's-length sales and arm's-length purchases at the lease of a portion of the lessee's production in a given field can be used to value its remaining production

MMS and many State commenters have been concerned about using tendering programs and arm's-length sales and purchases of a portion of a lessee's production to value the lessee's remaining production that is not sold at arm's length. Based on our experience under the current regulations, we have found that such methods are administratively costly and do not ensure that the American taxpayer receives market value for its oil production.

Therefore, MMS's proposed rule would require the lessee to use spot prices adjusted for quality and location differences everywhere except in the Rocky Mountain Region. The rationale for using spot prices is that they represent values assigned by the marketplace. Spot prices play a significant role in crude oil marketing and often represent the basis for price negotiations. They also are readily available to lessees and MMS through price reporting services and thus are fully transparent. Other than the Rocky Mountain Region, we believe that spot prices are the best indicator of value and that there is no need to consider other less accurate and more administratively burdensome methods to value production not sold at arm's length.

However, in the Rocky Mountain Region there is less spot market activity and trading, and neither MMS nor the commenters on the proposed rulemaking believe there is a spot price in that region that reliably reflects market value there. Thus, MMS's latest proposal for the Rocky Mountain Region, unlike for the rest of the country, applies a series of benchmarks for valuing oil not sold at arm's length. The first two of these benchmarks include prices received under tendering programs and prices received or paid in arm's-length sales and purchases by the lessee in a given field or area. (A spot price--for West Texas Intermediate crude at Cushing, Oklahoma, as adjusted for location and quality differences--would only be applicable as the third benchmark if neither of the first two benchmarks applied. And, if this third benchmark were inapplicable for the lessee's situation, the lessee could request the MMS Director to establish an alternative valuation method.)

In the case of the first Rocky Mountain benchmark, the price received by the lessee for oil that it offers and sells under an MMS-approved tendering program would be used to value the production that the lessee does not sell at arm's length. To be approved by MMS, a lessee's tendering program must meet minimum volume and bid requirements to assure that the price received represents market value. Under the second benchmark, the lessee could only use prices received or paid under arm's-length contracts if those sales and purchases comprise more than 50 percent of the lessee's production in the field or area.

<u>How MMS will address the issue of deductions for value added to oil moved downstream from the lease in order to derive a value of production at the lease</u>

Industry and MMS continue to dispute the concept of duty to market relating to the eligibility of marketing costs as royalty deductions. Longstanding case law says the lessee has a duty to market production for the mutual benefit of itself and the lessor at no cost to the lessor. Industry does not dispute this basic concept. But industry believes they incur midstream marketing costs, in addition to transportation costs, that they should be allowed to deduct. The MMS continues to believe that it should not share in any marketing costs, and in fact, would be derelict in its duties to do so.

Status Update

This report is a follow-up to a similar report submitted on June 3, 1998, in response to a request in House Report 105-337. The status below picks up where the June 3, 1998, report ended.

After considering all comments received in response to its proposed, supplementary, and second supplementary proposed rules, the multiple public workshops, and the request for comments on alternative methods, MMS once again opened the public comment period from July 9 through July 24, 1998. This was done to accommodate a request by Senator Breaux to broker a meeting with industry for the Department of the Interior (Department) to explain the direction it was going in its final rule. Two such meetings were held on July 9 and July 22. Summaries of minutes from those meetings were made available on the Internet on July 10 and July 24, respectively.

On July 16, 1998, in response to industry concerns raised at the two meetings, MMS published a further supplementary proposed rule clarifying some of the changes MMS intended to make when the proposed rule becomes final and requesting comment on an additional issue. These included:

(1) a return to the definition of "affiliate" used in the current rule,

(2) a clarification that the "breach of duty to market" language doesn't mean MMS would be second-guessing industry business decisions,

(3) a return to the concept that arm's-length proceeds received after a single arm's-length exchange would represent royalty value, but if more than one exchange occurs, index pricing would apply, and

(4) a request for comments on the definition of "gathering." This relates to deep water leases where production is moved from subsea completions to a distant platform. Typically such movement has been termed gathering, the costs of which are not eligible for a transportation allowance.

On July 21, 1998, Representatives Miller and Maloney sponsored a meeting between the Department, States, the Indian community, and multiple special interest groups. In that meeting the Department received a variety of comments that its most current proposed rule had gone too far in trying to accommodate comments by industry. Comments received during the meeting consistently condemned the April 1998 rider to the FY 1998 emergency supplemental spending measure that barred MMS from implementing the rule. A summary of minutes from this meeting was made available on the Internet on July 22.

The July 22, 1998, meeting involved further discussion of the industry issues with the proposed rule and their recommendations; these issues dealt with handling of arm's-length contracts, non-arm's-length contracts, duty to market, transportation, and non-binding guidance. At that time, Assistant Secretary Armstrong and MMS Director Quarterman agreed to provide immediate responses to these issues. The MMS responses were provided to attendees at the July 22 meeting and to the public via the Internet on July 24. The MMS further extended the comment period for the proposed rule until July 31, 1998, to permit comment on the industry recommendations and MMS's responses. On July 28, MMS and Departmental officials had another meeting with Senate staff members to further explain MMS's July 24 responses. Comments received at the meeting were posted on MMS's Homepage on the Internet on July 28 for interested parties to review during the comment period.

In August 1998, the General Accounting Office (GAO) provided its final report to the Committee and the Department on our efforts to revise the Federal oil valuation regulations. GAO provided an accurate description of the extensive effort we have undergone to obtain constituent input throughout this rulemaking.

We received 185 pages of comments from 24 entities on the July 16 further supplementary proposed rulemaking and subsequent meeting notes that we are currently reviewing. We are highly confident that the final rule, scheduled for issuance on October 1, 1998, will ensure an appropriate balance between the interests of industry, the States, and the Federal Government.